# WHAT ARE THE OECD'S VIEWS ABOUT THE MEXICAN TAX REFORM

Jean Philippe Cotis

***Why is stronger growth the overriding policy objective in Mexico?***

- Potential GDP growth fell recently below 4 per cent
  - This is too slow for Mexico, a country where incomes are still low and population is increasing fast.
  - It is also too slow to narrow the gap with other OECD countries.
- Achieving much higher growth for GDP per capita, while maintaining macroeconomic stability is therefore of utmost importance.
- We are talking about increasing the long-term growth to about 6 per cent per year (that is at least 2 points above current trends).

***Why are further reforms needed?***

To overcome obstacles to growth such as low levels of education, inadequate physical infrastructure and insufficient incentives to innovate, invest and engage into formal work. In a variety of areas meeting this challenge involves higher levels of public spending

***A sound tax system is key to ensure stronger and more stable growth***

A well designed tax system can bring about the additional public revenues which are needed to finance extra spending on strategic areas such as education and infrastructures. Importantly, it can do so with minimal economic distortions and in ways that better insulate the tax base from the vagaries of the business cycle and oil price fluctuations. Having a larger and more stable tax base is indeed crucial to secure the higher level of taxes and public spending that Mexico currently requires to boost its potential growth.

Over the recent years important progress has been achieved to broaden the tax base for personal income and corporate taxes. But further improvements could still be achieved.

The most important challenge is now to reform the VAT system with a view to:

- eliminating the distortions and social inequities that currently undermine it;
- and even more crucially to enhancing, through the VAT, the tax to P ratio.

All in all a well designed tax system can support growth, via higher and more predictable spending on infrastructure, human capital development, basic health programmes and targeted poverty relief, provided the overall size of the government is not excessive.

***Why is the policy debate in Mexico different from that in most other OECD countries?***

Mexico stands in sharp contrast to many other OECD countries where the issue is that public spending is too high, and whatever the structure of the tax system, the high tax burden (tax/GDP ratio) creates substantial distortions.

In Mexico, the tax/GDP ratio is very low and because of weaknesses in the tax design the associated economic distortions are unnecessarily large (*Figure 1*). This has imposed constraints on public spending. As mentioned before, the areas where more and better public spending would be conducive to faster economic development are:

- The education and training system, which is a case on its own. Additional resources could be used to address some of the shortcomings, including a backlog in investment, but as importantly, efforts should focus on using more effectively the resources that are being channeled to the system. *(Figure 2. Education indicators)*

- Spending on physical infrastructure should be at a higher level; and the financing should not be subject to stop and go behaviour. Although effective in meeting budget targets “cyclical cuts”, caused by volatile financing, almost certainly affect programmes which are essential for Mexico’s development, thus jeopardizing the effectiveness of expenditure.

- Additional spending on basic health care would also contribute to improving human capital. (*Figures 3. Health care spending in the OECD)*

- And preserving social programmes, including targeted poverty relief (known as PROGRESA/*Oportunidades*), from drastic cuts is also important. *(Figure 4. Social spending)*

To sum up, public expenditures are relatively low in proportion to GDP and they are excessively volatile, because they are largely financed by oil-related revenue, vulnerable to world oil price changes. Freezing or cutting public spending, as currently practiced to ensure budget discipline in the face of revenue shocks, is costly in the longer run.

The fact that optimal spending is hampered by low tax revenue raises delicate public choice issues. In those circumstances public authorities have to decide whether or not to: 1°) increase public debt; 2°) raise tax revenues; or 3°) maintain low and volatile spending levels. More deficit financing does not seem to be presently an option because government obligations are already substantial[1]. [2]There is a clear risk that increasing the debt burden would undermine investors confidence thus outweighing the benefits of additional spending. The second option seems more promising: that is increasing the tax take in order to finance expenditure, with high economic and social benefits, while keeping a small-size government and minimizing the tax burden through an optimized tax structure.

---

[1] The public sector debt, including fiscal obligations related to the bank rescue programmes and the (privately-financed) long-term investment schemes of the public sector, amounts to close to 42 per cent of GDP. In addition there are obligations associated with the inevitable reform of the public sector pension system

***Why is a tax reform important for Mexico?***

Once it is established that more tax revenue should be raised to finance "good" spending, the question is how to do it? Most often, the challenge is to do it while minimizing economic distortions. In Mexico, the trade off between higher public spending and stronger distortions seems far less acute. To the point where spending could be increased while reducing economic distortions. This possible double dividend stems from the fact that despite its strong points Mexico's tax system exhibits weaknesses that could be profitably addressed. The areas where improvements could be achieved are the following:

1. The tax system does not generate enough revenue;

2. as a consequence, there is excessive reliance on volatile oil-related revenue;

3. Given the lower tax/GDP ratio, the tax system creates unnecessary distortions. The narrow tax base means that tax rates are higher than they need to be for a given revenue, negatively affecting agents decisions. This is against the "good" taxation principles of having a wide tax basis associated with low tax rates.

The main concerns regarding the tax system are the numerous preferential regimes and the closely related deficiencies in tax administration. Although substantial progress has been achieved in Mexico over the recent years in those areas it is still the case that:

- Preferential regimes (or tax expenditure in a broad sense) lead to low revenues *per se;*

- They complicate tax administration, opening multiple possibilities for non-compliance and facilitating evasion. As a consequence, the tax administration is not a position to deal adequately with the complexities created by the legislation.

- They also create major problems of horizontal inequity (some pay taxes, others do not), as well as vertical inequity (medium and large corporations under the "special regime" avoid income taxation).[2]

***What kind of a tax reform is needed?***

In Mexico the problem is not the tax mix, which is not very different from other OECD countries but rather the low share of tax revenues in GDP combined with unnecessary complexities in the tax design (Figure 5. *Structure of taxation in OECD countries*). As a consequence, the key challenge facing the tax system is to increase the potential revenue raising capacity, primarily by broadening the base and improving collection, while keeping the rates near the current low levels.

Regarding direct taxation, good progress was achieved through the last tax package (December 2001). Mexico is moving in the right direction but could move even further.

Regarding consumption taxation, a lot needs to be done and can be gained through an ambitious and wholesale reform.

2 The existence of numerous preferential regimes, in particular, create uneven incentives across various economic activities. For instance, enterprises from a few specific sectors – agriculture, fisheries and land transportation - benefit from a "simplified regime » under the corporate income tax regime. Taxation is based on cash flows and only on resources withdrawn from the enterprise. Furthermore these enterprises only pay half the standard income tax rate (i.e. 17 per cent instead of 34 per cent in 2003).

### *A. Broadening the tax base for VAT*

General taxation on consumption has the advantage of creating little distortion while raising revenue from a relatively stable tax base. The most important area to tackle is VAT.

- A reform on VAT could contribute to both better equity and efficiency.

**Box 1. Broadening the VAT base**

There are very many exemptions and zero-rated goods and services under the Mexican VAT regime. Exemptions other than the standard ones include public transport of passengers by land, agriculture, forestry and fishing activities. Zero-rated goods and services include medicines, food except processed food, milk, water, agricultural machinery, fishing boats.

The exemptions and zero-rated base :

- result in a significant reduction of the base of taxed consumption; and

- contribute to low VAT compliance, as some transactions are falsely attributed to the zero-rated base.

By some estimates only around one half of total consumption is taxed. Moreover, the system of refundable VAT credits exacerbates the incentives to fraud and complicates administration further. According to the authorities' estimates, VAT compliance in Mexico is only around 63 per cent -- *i.e.* only 63 pesos were collected out of every 100 pesos that should have been collected. This is below compliance levels in other OECD countries for which comparable data are available, including Canada and Portugal, as well as some Latin American countries.

The narrow base and the induced low compliance implies that Mexico ranks lowest among the OECD countries in terms of VAT productivity.[3] This is also the case for the effective VAT rate[4] in per cent of standard rate -- again indicating that only a small part of the potential base is actually being taxed (Figure 6).

*Figure 6. VAT collection indicators*

Zero- rating of basic staples, such as food and medicine, is a very inefficient way of using taxes for redistribution. People at higher income levels are actually compensated more in absolute terms than low-income people. They are being heavily subsidised by the non-taxation of food in particular (Figure 7).

*Figure 7. VAT "subsidy", 2000*

Reducing the preferential treatment of consumption by eliminating massive zero rating and exemptions under VAT would also be a way of taxing the most affluent households at higher effective rates. According to official estimates and considering the distribution by income deciles, the highest two deciles would be bearing half of the burden of additional taxation from a tax base widening, while the lowest two deciles would only pay 3.1 per cent of the additional burden and could be compensated by other means.

This would strengthen revenue significantly without necessarily increasing distortions, and at the same time it would alleviate problems of horizontal inequity and help reducing budget volatility.

### *B. Broadening the base of the income tax*

On the income tax front, some action has been taken. The 2001 tax measures eliminated various preferential regimes both for corporate and individual tax payers. The top marginal rate of individual

3. The VAT productivity is a standard measurement of the revenues collected per percentage point tax, *i.e.* VAT revenues in per cent of GDP divided by the standard VAT rate. Although a relatively rough indicator it provides some guidance for international comparison.

4. VAT revenue divided by total consumption exclusive of VAT revenues.

income tax is being gradually reduced (the number of brackets was also cut down), and the income from all sources is now subject to the same tax rate.

However there remain some areas where further reform could be made to widen the tax base. Two areas of improvement could be considered: i) getting rid of the simplified regime for certain sectors and ii) taxing more comprehensively fringe benefits. [5]

**Box 2. Widening the income tax base**

***Under the corporate income tax***, it may be useful to do away with the simplified regime for certain sectors.

There is also a small taxpayers regime; but it serves the useful purpose of making formal sector economic activity more accessible, in terms of less complicated rules and requirements for the self employed and micro-businesses.

On the other hand, there seems to be little economic justification for the special treatment of entire sectors under the simplified regime. The sectors benefiting from the *simplified regime* -- *i.e.* agriculture, fisheries and land transportation, which together represent around 10 per cent of GDP and 25 per cent of total employment -- pay only little or no corporate income tax.[6] A large part of taxpayers in these sectors are small family-run businesses that would be lightly taxed in any circumstance (under the regime for small taxpayers). However, medium and large sized corporations in agriculture and land transportation also are avoiding income taxation under the simplified regime.

***In the individual income-tax system,*** the non-taxation of fringe benefits leaves around one-third to one-fourth of total labour income in the formal sector untaxed. Moreover, the non-taxation has necessitated the introduction of a tax rebate -- the fiscal subsidy -- for those receiving a relatively small share of remuneration as fringe benefits, in order to mitigate adverse consequences for horizontal equity. This, in turn, means that tax revenues and the base of taxpayers are lowered further and adds to the complexity of the tax system. Fringe benefits are included in the income-tax system in most OECD countries,[7] but the tax treatment of different types of fringe benefits varies significantly across countries.

In sum, Mexico applies preferential regimes on a broad range of economic activities and incomes -- a practice which causes a major drag on tax revenues, uneven incentives across activities and severely complicates tax administration. A rough calculation would suggest that the direct effect of completely eliminating the major preferential regimes described above could provide several percentage points of GDP in additional tax revenues. In addition to the direct revenue-enhancing impact of a wider tax base, there would be positive revenue effects from increased compliance, as preferential regimes are removed.

Two other potential areas for increasing tax capacity would be excises and taxation of property. On both accounts, Mexico falls behind most other OECD countries and also some of its Latin American neighbours. These are not the most critical points and we will not discuss them now.

5. The immediate deduction scheme for investment by corporations outside the three largest metropolitan areas, which was re-introduced in 2003, although comprising some economic rationale in terms of supporting investment and regional development, also creates unintended loopholes and distortions.

6. Taxation is based on cash flows, and only on resources withdrawn from the enterprise. Moreover, enterprises in agriculture, fisheries and publishing only pay half the standard rate, *i.e.* 17 per cent of taxable income and 0.9 per cent in assets tax.

7. The most widely used fringe benefits in OECD countries are food, discounts, transportation, leisure facilities, accommodation, medical and dental insurance, financial insurance and education expenses. For Mexico the non-taxed fringe benefits also includes child care, while excluding food and accommodation. Nearly all OECD countries tax employer-provided motor vehicles and accommodation, and nearly half of the countries tax insurance arrangements and leisure facilities.

## Conclusion

- Tax reform should be put on the policy agenda again.

- The desired tax reform should be designed to bring in additional revenue without creating distortions.

- The best way to do this is to widen the VAT base. Going further in the income tax reform would also contribute to increasing the tax take, while reducing distortions:

- Compensation to low income groups is probably necessary to make the broadening of the VAT base politically viable.

- The kind of compensation to choose should not divert attention from the significant budgetary gains that are likely to arise in any circumstance from eliminating zero-rating and exemptions in the VAT regime.

- Broadening the tax bases would also contribute greatly to improve the effectiveness of tax administration.

***What are the OECD’s view about the Mexican tax reform***

14-15 October 2003

*By Jean-Philippe Cotis*

# *Why is stronger growth the overriding policy objective in Mexico?*

- Potential GDP growth fell recently below 4 per cent
  - This is too slow for Mexico, a country where incomes are still low and population is increasing fast.
  - It is also too slow to narrow the gap with other OECD countries.
- Achieving much higher growth for GDP per capita, while maintaining macroeconomic stability is therefore of utmost importance.
- We are talking about increasing the long-term growth to about 6 per cent per year (that is at least 2 points above current trends).

## *Why are further reforms needed?*

- To overcome obstacles to growth such as:
  - low levels of education
  - Inadequate physical infrastructure
  - and insufficient incentives to innovate, invest and engage into formal work.
- In a variety of areas meeting this challenge involves higher levels of public spending

## *A sound tax system is key to ensure stronger and more stable growth*

- A well designed tax system can bring about the additional public revenues which are needed to finance extra spending on strategic areas such as education and infrastructures.

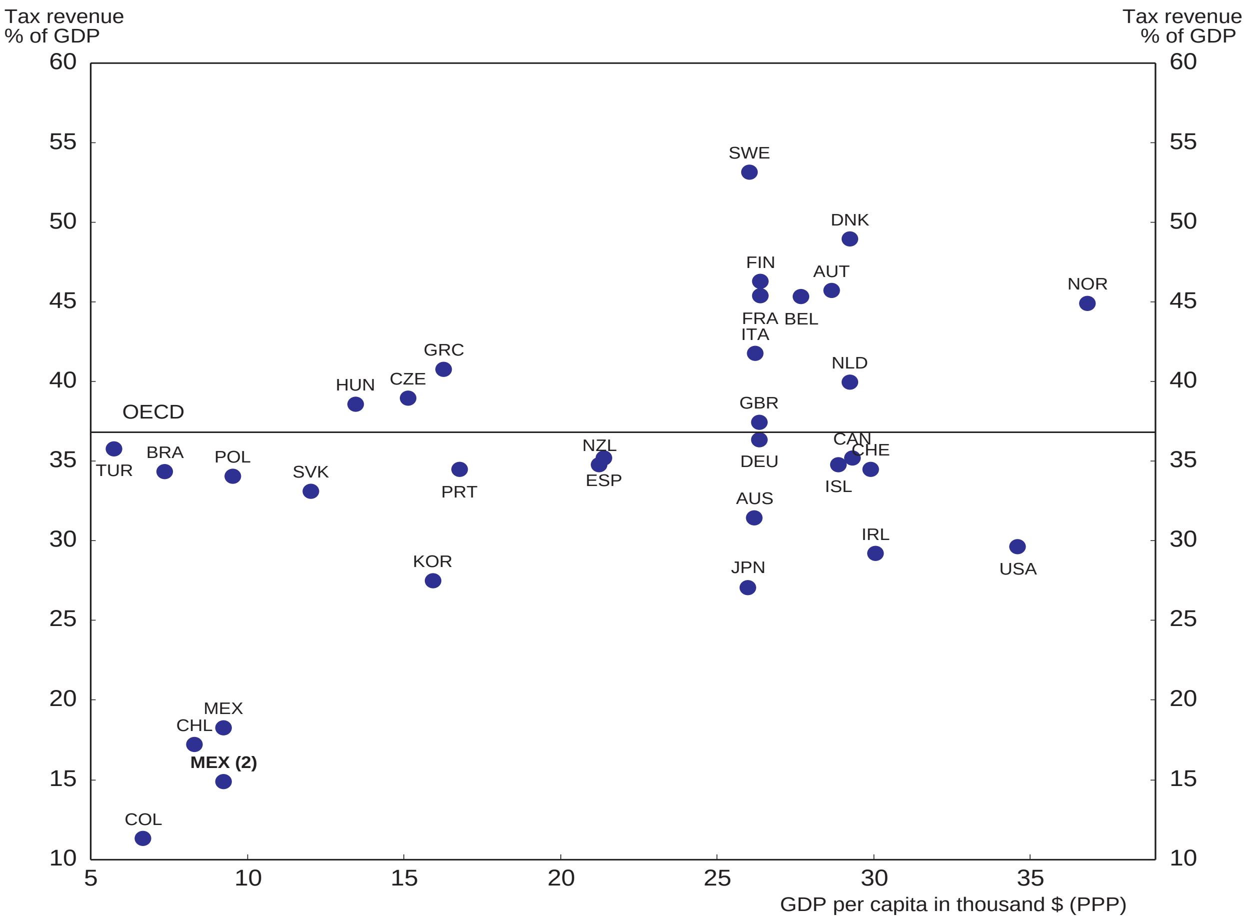
- Importantly, it can do so with minimal economic distortions and in ways that better insulate the tax base from the vagaries of the business cycle and oil price fluctuations.

- Having a larger and more stable tax base is indeed crucial to secure the higher level of taxes and public spending that Mexico currently requires to boost its potential growth.

## *The most important challenge is now to reform the VAT system with a view to:*

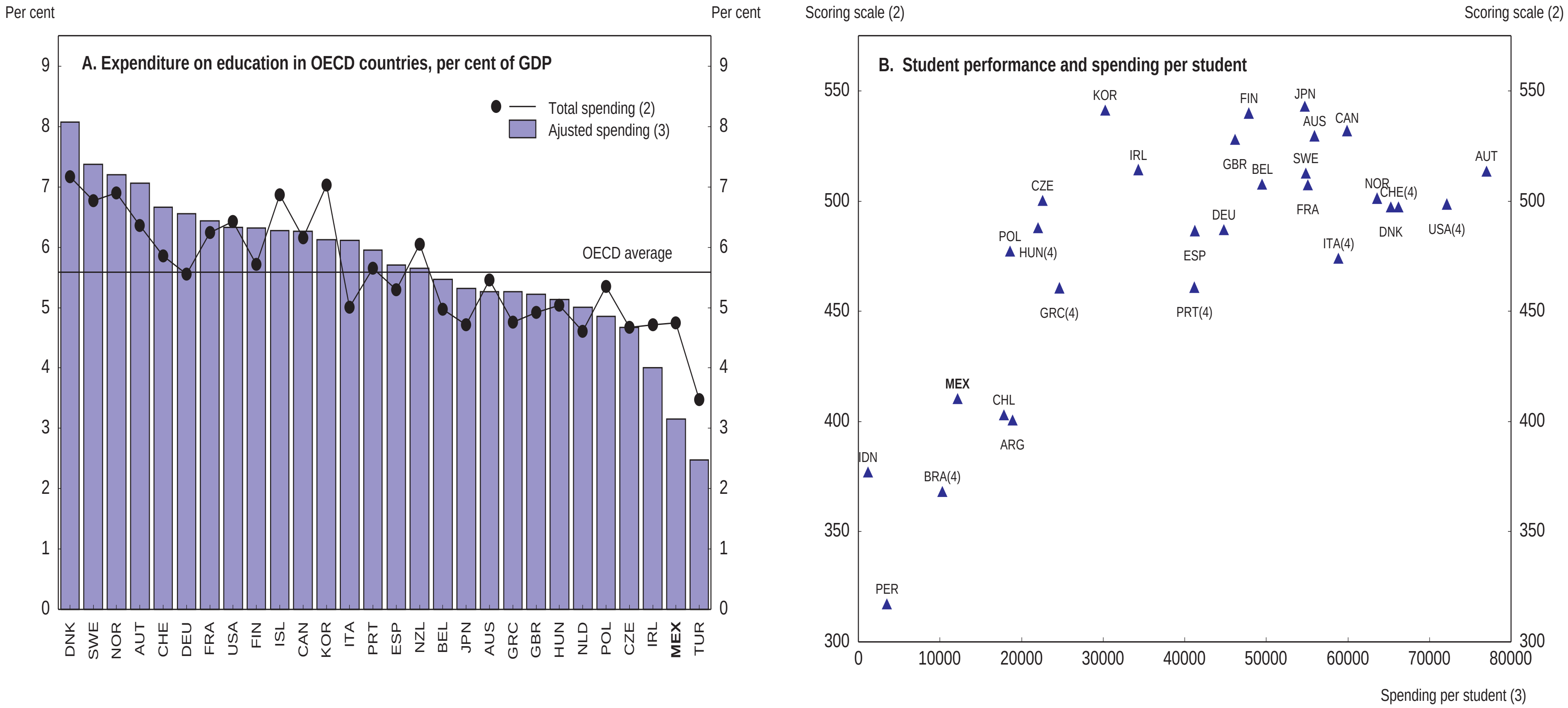
- eliminating the distortions and social inequities that currently undermine it;
- and even more crucially to enhancing, through the VAT, the tax to GDP ratio.
- All in all a well designed tax system can support growth, via higher and more predictable spending on infrastructure, human capital development, basic health programmes and targeted poverty relief, provided the overall size of the government is not excessive.

# Figure 1. Tax revenue and the level of income in comparison




1. 2001 or nearest year available. Including social security contributions. Unweighted average for OECD.
2. Excluding PEMEX contributions to the Federal Government.
Source: OECD; Inter-American Center of Tax Administrations; World Bank.

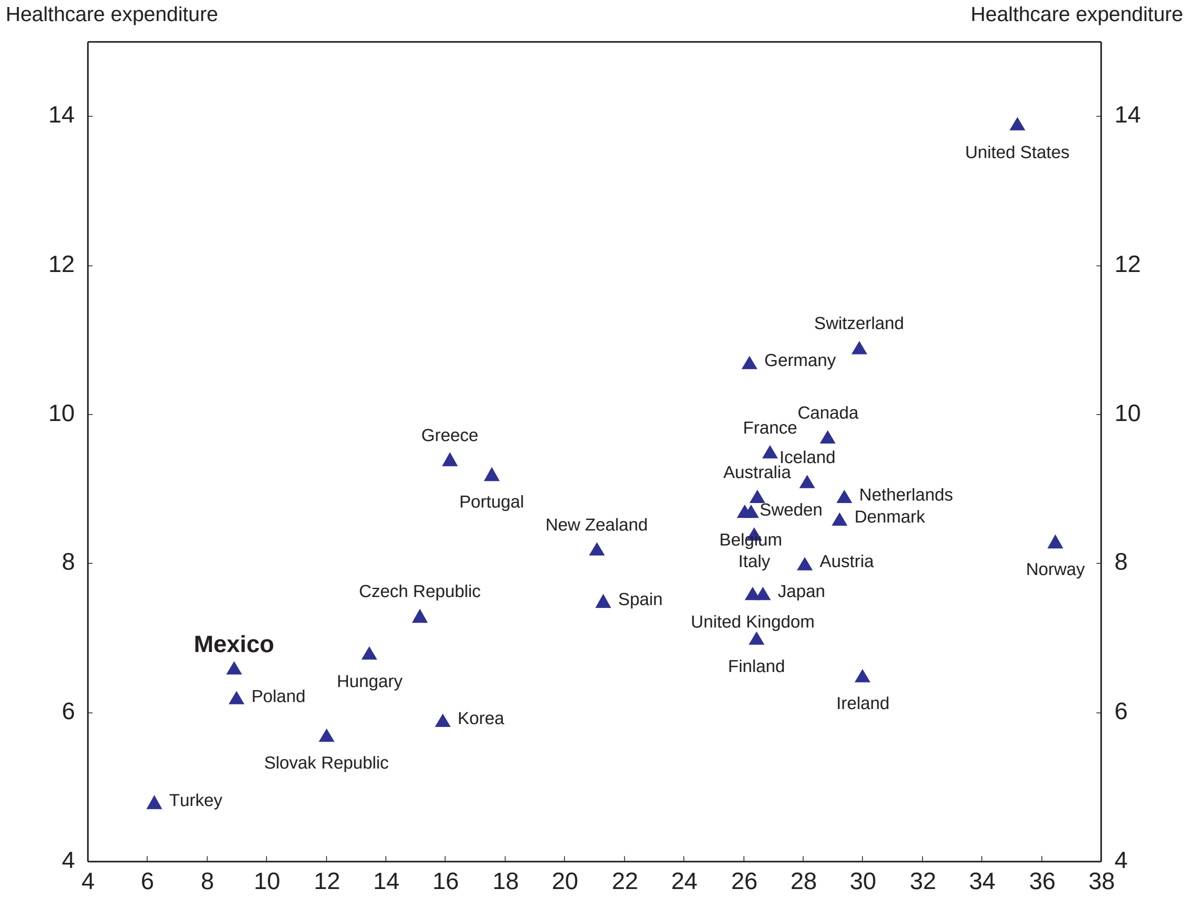
# *Figure 2. Education indicators*




1. In 1999 or nearest year available. Countries are ranked according to adjusted spending in that year.
2. Public and private spending.
3. Adjustment to take into account the difference in the proportion of population aged 5 to 29 of each country relative to the OECD average.

Source: OECD.

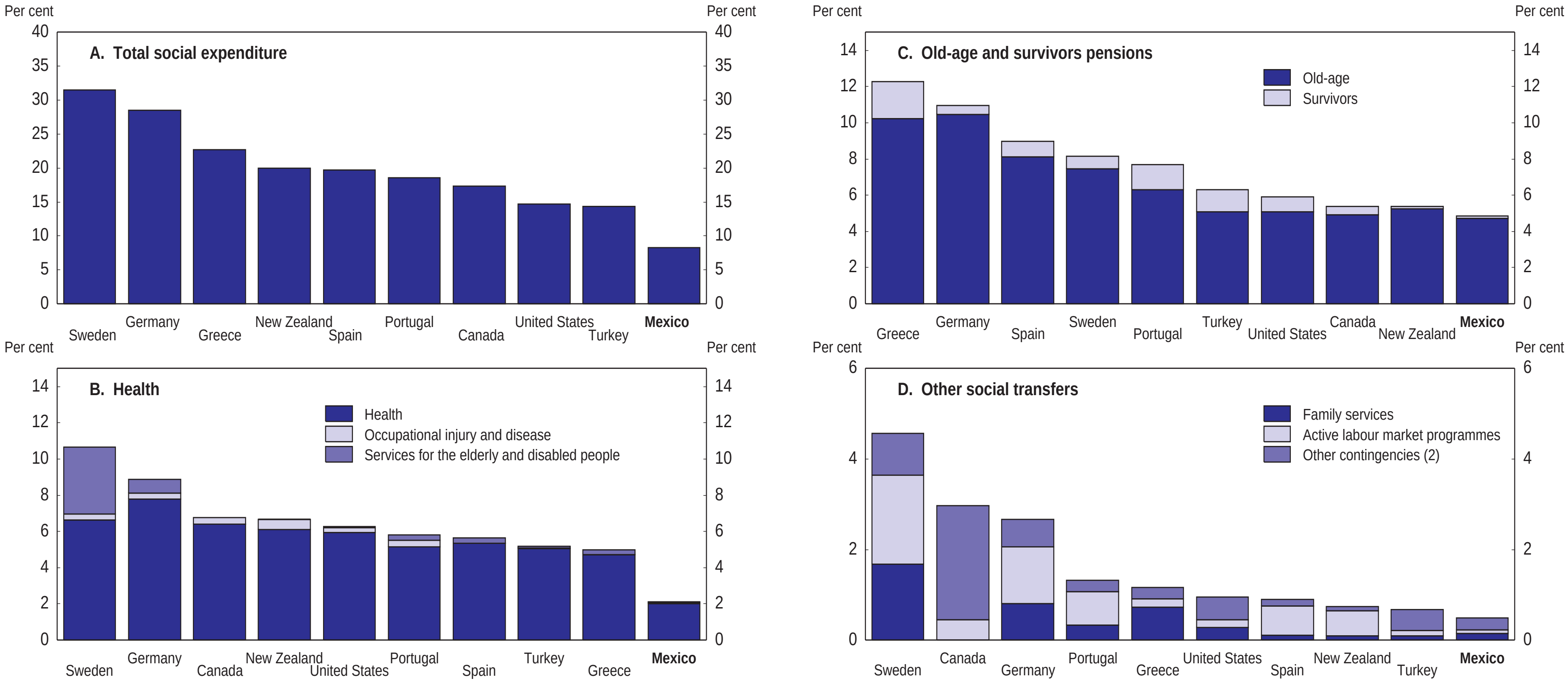
# *Figure 3. Healthcare expenditure and GDP per capita (1)*
# *Per cent of GDP*




1. In 2001 or latest year available.
Source: OECD, Health Data 2003.

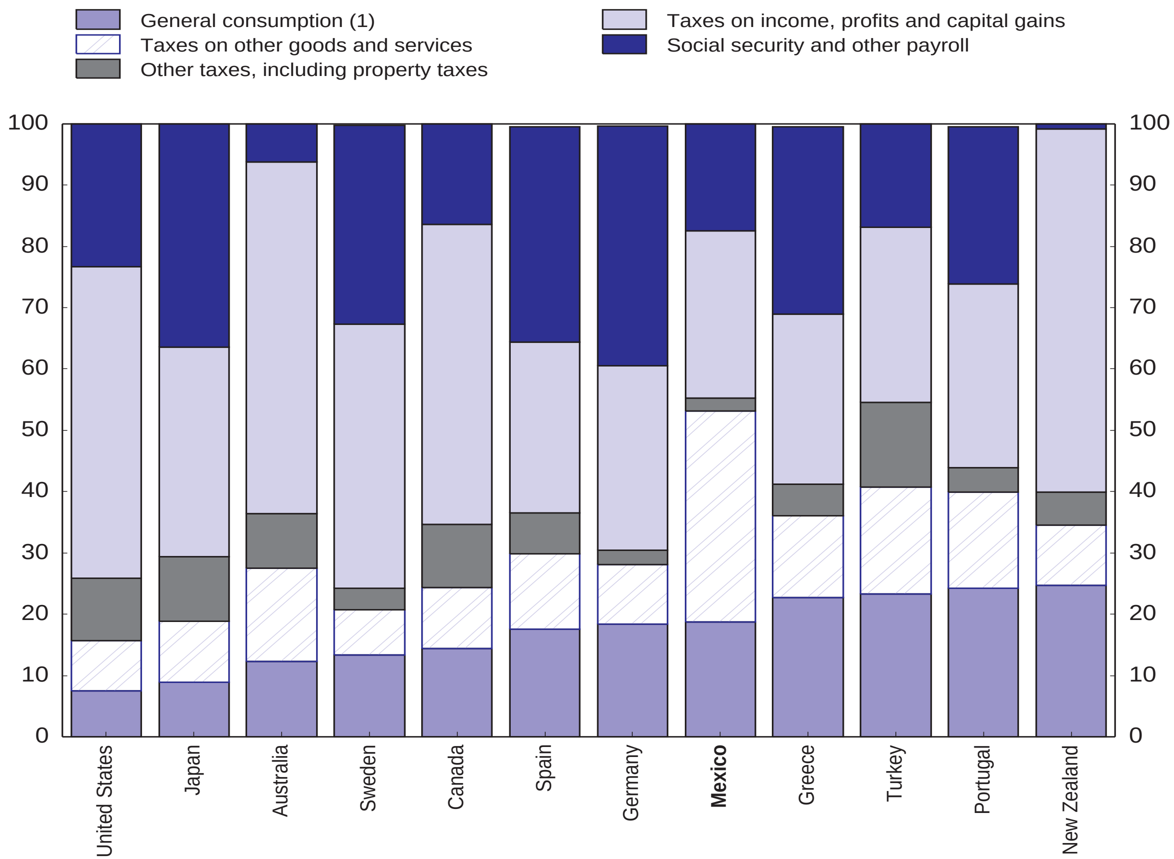
GDP per capita in thousand $ (PPP)

## *Figure 4. Social expenditure in selected OECD countries (1)*
## *Per cent of GDP*



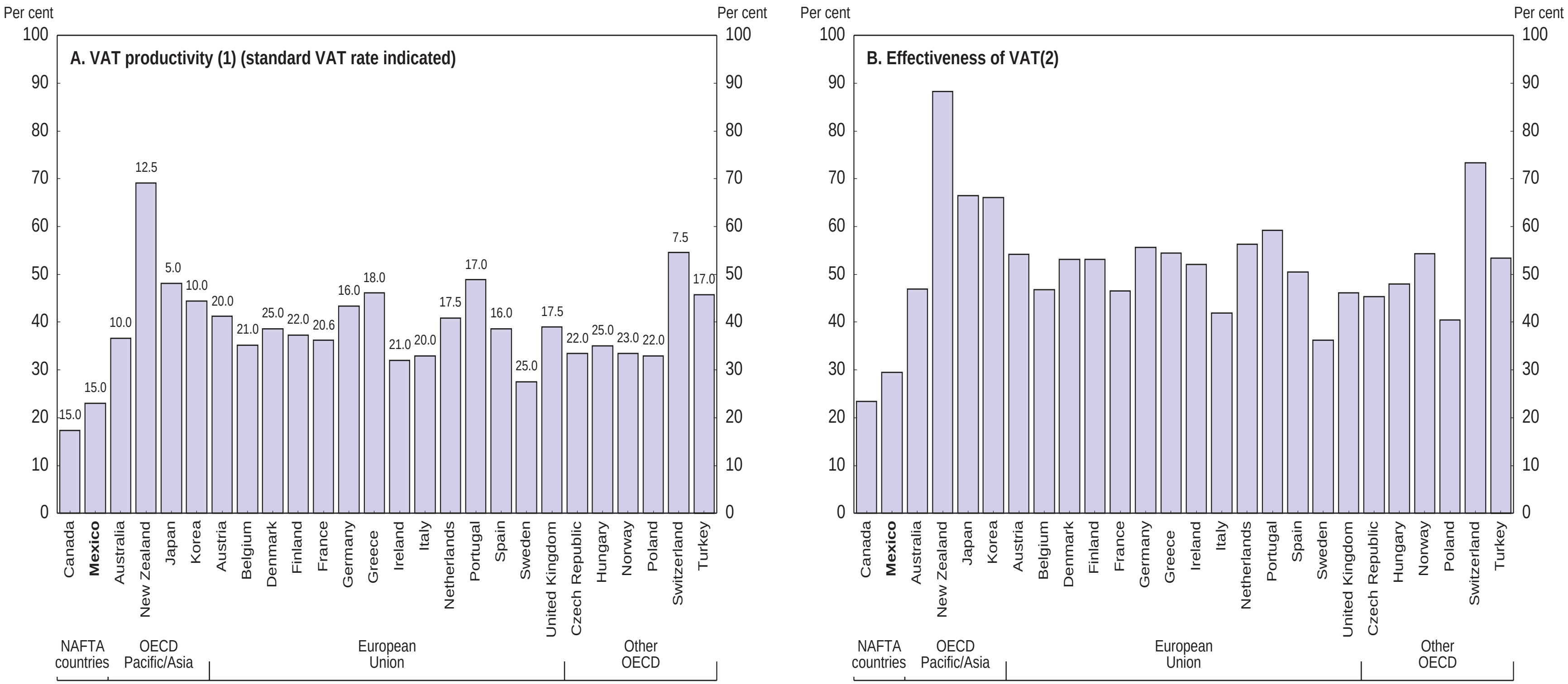

1. In 1999 or latest year available.
2. For Mexico, mainly targeted programmes of Solidaridad.
Source: OECD, Social Expenditure Database.

## Figure 5. Tax mix in selected OECD countries, 2000
## Per cent of total tax revenue



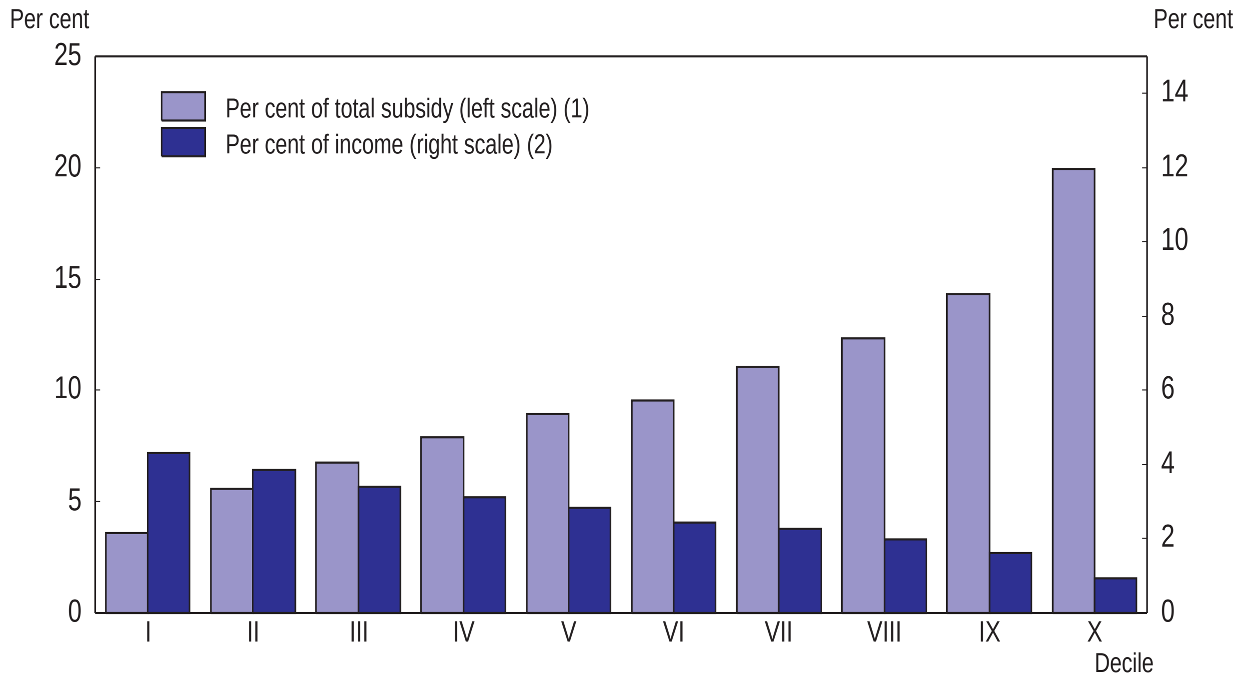

1. Value added taxes, sales tax and other general taxes.
Source: OECD.

# *Figure 6.   Indicators of VAT collection, 2000*




1. VAT productivity is VAT revenue in per cent of GDP divided by standard VAT rate.
2. Effectiveness of the VAT is measured as the effective VAT rate as  a per cent of the standard statutory rate, where the effective rate is VAT revenues divided by the potential VAT base (i.e. total consumption minus VAT revenues).
Source:   OECD.

# *Figure 7. Distribution of implicit VAT "subsidy", 2000*




1. The implicit VAT subsidy at each income decile is estimated by the corresponding expenditure on food multiplied by the standard VAT rate of 15 per cent.
2. The consumption of food and household income per decile (referring to total income) are based on the INEGI 2000 Household Survey.

Source: INEGI, "Encuesta nacional de ingresos y gastos de los hogares 2000"; OECD calculations.

# ***Conclusions***

- Tax reform should be put on the policy agenda again.
- The desired tax reform should be designed to bring in additional revenue without creating distortions.
- The best way to do this is to widen the VAT base.
- Compensation to low income groups is probably necessary to make the broadening of the VAT base politically viable.
- The kind of compensation to choose should not divert attention from the significant budgetary gains that are likely to arise in any circumstance from eliminating zero-rating and exemptions in the VAT regime.